Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Romero	Analyst:	Marion Mann DeJong	Bill Number:	SB 1400
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/13/2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Action To Determine Validity Of Amount Of Tax

SUMMARY

This bill would allow a taxpayer to post a bond instead of paying the disputed taxes while challenging an assessment in court.

This analysis will not address the bill's changes to the Sales Tax Law, as they do not impact the department or state franchise or income taxes.

PURPOSE OF THE BILL

According to the author's staff, this bill is intended to provide taxpayers with a fair remedy to proceed to court without having to pay their entire tax liability.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2003. However, the bill specifies that it would apply to assessments that become final before, on, or after the effective date (January 1, 2003). However, the bill does not authorize the filing of any action that is barred by operation of law, including an action prevented by the doctrine of res judicata. Res judicata has the effect of preventing a party to an action from re-litigating a case that has already been decided.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under current federal law, a taxpayer that disputes an assessment made by the Internal Revenue Service (IRS) and loses an administrative protest or appeal may either:

- seek judicial review of the assessment in Tax Court without paying the tax, or
- pay the assessment and file a formal claim for refund with the IRS and appeal any action to a U.S. district court or Court of Federal Claims.

Board Position:			Department Director	Date
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California law generally requires a taxpayer to pay a disputed tax prior to taking action in court. In the case of income or franchise taxes, a taxpayer that disputes the validity of a tax assessment and loses an administrative protest with the Franchise Tax Board (FTB) can:

- appeal directly to the Board of Equalization (BOE) without paying the tax, or
- pay the proposed assessment and file a claim for refund. If the claim is denied or no action is taken on the claim within six months, the taxpayer may further pursue an appeal to the BOE or initiate legal action for a refund in superior court.

The California Constitution (Article XIII, Section 32) prohibits a taxpayer from using legal or equitable procedures, such as declaratory judgments or injunctions, to restrain or inhibit the assessment or collection of taxes. The taxpayer's remedy is to pay the tax and seek a refund. An exception is provided for suits contesting a *residency determination.* Such cases are allowed without prepayment of tax and have been held not to violate the California Constitution.

See "Appendix A" attached for more information on federal and state law regarding the tax dispute process.

THIS BILL

This bill would allow a taxpayer desiring to challenge an assessment of income or franchise taxes in court to post a bond[1] instead of paying the disputed taxes. The bond must guarantee the amount of tax assessed by FTB and any interest and penalties that may be expected to be due within the first year of the court action. The bond would not prevent the accrual of interest on the disputed amount. No penalty for late payment would be assessed upon the disputed tax assessment with respect to which the bond is filed.

The amount and terms of the bond and the sureties on the bond would be required to be approved by a judge of the trial court hearing the action. The court would follow the rules, definitions, and procedures set forth in specified sections of the Code of Civil Procedure. The bill provides that approval should not be unreasonably withheld. If the bond were approved, no collection action on the tax or other assessed amount that is subject to the action would be taken while the action is pending.

The plaintiff (or the plaintiff's agent or attorney) would be required to state under oath that a bond was approved and filed.

If during the time that the action is pending the trial court determines that the amount of the bond has become insufficient, the taxpayer must increase the amount of the bond to provide sufficient guarantee. In addition, FTB may annually require the plaintiff to increase the amount of the bond to guarantee additional interest accruing during the year. FTB must make the request to increase the bond in writing. The plaintiff would have at least 60 days from the date of the notice to increase the amount of the bond or, as an alternative, to pay the additional interest accruing during the year.

The trial court may enforce the liability on the bond if the assessment is determined to be valid and is not paid within 30 days after the judgment on the action becomes final.

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[1] A bond is a financial document or contract that guarantees payment of a liability. Generally, a bond can be purchased through a surety company for an amount much less than the actual liability (e.g., $10 per $1,000 liability). In the case of this bill, the taxpayer would obtain a bond from a surety company and provide it to the court or FTB to guarantee the tax liability while the tax dispute is being resolved.

IMPLEMENTATION CONSIDERATIONS

Since this bill would allow taxpayers to initiate a lawsuit by posting a bond rather than paying the full liability, more taxpayers may take their cases directly into court without adjudication before the BOE. This would result in increased litigation workloads. Further, if taxpayers and the department dispute whether the bond is sufficient to guarantee the payment of the assessment, increased litigation workloads could result.

LEGISLATIVE HISTORY

This bill is identical to AB 1392 (Hertzberg, 1999/2000). AB 1392 was held in Senate Appropriations Committee in September of 1999 and was returned to the Senate without further action in January 2000.

AB 41 (Wesson, Stats. 1999, Ch. 463) allows taxpayers to post a "cash bond" to stop the running of interest while retaining their rights for claims and suits.

AB 2678 (Pringle, 1997/1998) would have allowed a taxpayer to obtain a restraining order or injunction to prohibit the assessment or collection of taxes by filing a statement with the Attorney General and either paying the amount due or posting a bond to guarantee payment of the amount due. AB 2678 failed passage in the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The laws of *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws. All these states generally provide an administrative or quasi-judicial review process that allows taxpayers to appeal assessments without prior payment of taxes. In addition, *Massachusetts* and *Minnesota* taxpayers may appeal to the court system without prior payment. In *New York*, some taxpayers that appeal to the court system are required to pay the tax or post a bond for the amount of the tax, interest, and penalty.

FISCAL IMPACT

The departmental costs associated with this bill are unknown. The costs could increase, however, to the extent that more taxpayers litigate.

ECONOMIC IMPACT

Revenue Estimate and Discussion

No specific revenue impact can be developed in advance of enactment of this bill since the number of taxpayers posting bonds and the amount of the disputed tax liabilities are unknown. To the extent that taxpayers make use of provisions in this proposal, collection of revenues would be delayed and state litigation costs would increase.

As of December 31, 2001, there were 838 appeals in progress that totaled approximately $260 million. Under this bill, collection of potentially tens of millions of dollars could be significantly delayed, having a considerable negative impact on the state's cash flow beginning in 2002-03.

LEGAL IMPACT

The provisions of this bill could be susceptible to challenge under the California Constitution since Article XIII, Section 32 specifically provides that no legal or equitable process shall issue in any proceeding in any court to prevent or enjoin the collection of any tax. If a taxpayer posts a bond, rather than paying all amounts due, and brings an action, this bill would prevent collection while that action is pending. However, Legislative Counsel opined in April 1999, that the Legislature could enact a valid statute that authorizes a taxpayer to commence a prepayment action to contest a disputed tax.

ARGUMENTS/POLICY CONCERNS

According to information provided by the supporters of AB 1392 (Hertzberg, 1999/2000), California is unique among western states, and in a small minority nationally, in requiring a taxpayer to pay the full amount of a tax assessment prior to challenging the tax in court. Among western states, only Idaho requires any sort of prepayment of the disputed assessment, and then the prepayment is only equal to 20% of the tax.

This bill would allow taxpayers to challenge tax assessments in court without having to pre-pay their tax liability. Proponents argue that this is a taxpayer right in most other states and at the federal level. And they indicate that the prepayment requirement effectively and unjustly deprives many taxpayers of their right to a judicial determination of tax liability. They argue that the current system tends to force taxpayers to settle with the tax agencies even when they believe they would prevail in court.

This bill would allow a taxpayer to stop collection of a tax until the validity of the tax is adjudicated in court. In some instances, adjudication and potential appeals can take many years. While posting a bond may ensure eventual payment of taxes and interest in the event the taxpayer loses, California would not have the revenue available while the litigation is pending. Further, while this bill would allow taxpayers to proceed to court at a reduced cost (bonds typically can be obtained for a fraction of their face value, like bail bonds), the purpose of the constitutional bar against injunctions of tax assessments and collections is to ensure that the collection of revenue is uninterrupted.

This bill may confuse taxpayers. A taxpayer will get no deduction on the federal return for California taxes paid if they post a bond. However, once the bond is converted to a payment of tax a deduction could be taken on the federal return. Further, taxpayers can stop the running of interest by paying the proposed deficiency under protest (automatic claim for refund), and if they are successful, the overpayment is refunded with interest to the taxpayer or credited against other liabilities. Taxpayers that choose to post bonds rather than pay the proposed assessment under protest will earn no interest if they prevail and the bond is returned.

This bill would allow a taxpayer to go to court without a prior administrative claim or review. This results in two changes to the current process. First, it could shift the discovery of facts and records from being conducted during protest and appeal to being conducted during the discovery phase of the litigation. Second, it would allow taxpayers to present the basis for their dispute for the first time in a cause of action authorized by this bill.

LEGISLATIVE STAFF CONTACT

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Appendix A

Tax Dispute Process

Under current federal law, taxpayers must first attempt to resolve objections to IRS audit findings through the IRS administrative process. In the event the IRS is unable to reach agreement with the taxpayer, the taxpayer may either:

- seek prepayment judicial review of the assessment in Tax Court (which has a small claims division for amounts of $50,000 or less), or
- pay the assessment and file a formal claim for refund with the IRS and appeal any action to a U.S. district court or Court of Federal Claims.

Current federal law allows a taxpayer to file a petition with the Tax Court for a redetermination of a deficiency within 90 days (150 days if addressed to persons outside the United States) after the notice of deficiency is mailed. No final assessment of a deficiency may be made until after the expiration of the 90-day period, or if petition is filed, until the decision of the Tax Court is final.

Current federal procedures (Rev. Proc. 84-58) allow a deposit in the nature of a cash bond while a deficiency is pending in administrative proceedings or Tax Court. The bond amount may be refunded without interest at any time, and if the taxpayer prevails in administrative proceedings, the entire bond may be refunded to the taxpayer without interest. This is an important strategic tool for taxpayers because a taxpayer can make a payment in the nature of a cash bond to stop the accrual of interest while preserving the jurisdiction of the Tax Court to review the underlying deficiency. A Tax Court decision can be appealed all the way to the Supreme Court without payment of the deficiency. However, collection of amounts affirmed by the Tax Court is not stayed during appellate review when a bond is posted with the court.

Under federal law and procedures, if during the administrative review or appeals process a taxpayer pays the deficiency rather than posting a cash bond, no deficiency is issued and taxpayers are precluded from challenging the assessment in Tax Court. The taxpayer must start over from the beginning with a refund claim that is treated as a new case. The taxpayer must then appeal any IRS action on the new refund claim to a U.S. district court or the U.S. Court of Federal Claims rather than the Tax Court.

Under current state law, if the taxpayer disputes a proposed assessment, the taxpayers can either:

- protest the proposed deficiency assessment or jeopardy assessment by filing a written "protest" with FTB[2], or
- pay the proposed assessment and file a claim for refund.

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[2] The protest of a proposed deficiency or the appeal of FTB's denial of a taxpayer's protest may be converted to a claim for refund upon payment of the underlying deficiency, without the necessity of starting a new administrative process.

Once the tax is paid, taxpayers have the longer of one year from the date of payment or four years from the date the original return was due to file a formal claim for refund to assert all bases for their dispute. If the claim is denied or no action is taken on the claim within six months the taxpayer may further pursue an administrative remedy by an appeal to BOE or initiate legal action for a refund in superior court.

The taxpayer's administrative forum for appealing an adverse FTB action is the BOE. The BOE is the first independent administrative level of review of an FTB action. During the appeal process, the BOE makes an independent determination of the action. The BOE accepts evidence submitted by the taxpayer and, if requested by the taxpayer, grants an oral hearing on the matter. In the event of a final adverse BOE decision on appeal, the proposed deficiency becomes final and is assessed, and the taxpayer’s recourse is to pay the amount due and bring an action for refund against the state in superior court.

Current department practice with respect to payments of tax made during an audit is to treat them as payments for the year in question and to show them as payments reducing the balance due when a proposed deficiency assessment is finally issued. If the payments exceed the proposed assessment amount, the excess is refunded with interest.

Rather than paying the underlying tax in full before action is taken on a protest or appeal, a taxpayer can instead make a cash bond deposit with FTB to stop the running of interest. A cash bond is a deposit by the taxpayer in the amount of the disputed tax that is held by FTB pending the conclusion of the protest or appeal. The cash bond is not considered a “payment of tax” for the purpose of filing a refund claim or bringing an action until either 1) the taxpayer provides a written statement to the FTB specifying that the deposit shall be a payment of tax, or 2) the proposed deficiency is a final assessment and is due and payable.